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SUBJECT: TURKEY'S LOOMING ELECTRICITY DEFICIT

REF: A: ANKARA 3716
B: ANKARA 2877

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Sensitive But Unclassified. Please handle accordingly.

11. (SBU) SUMMARY: With growing fears of an electricity supply deficit in Turkey before the end of the decade (Ref B), the Turkish government has announced plans to move forward more quickly on privatization and establishment of an electricity market for pricing and settlement. Meanwhile, long fixed consumer prices have squeezed the one significant part of the electricity industry intended to react to market signals: those which produce for their own needs and sell the excess to the grid ("autoproducers"). The July 1 black out has spurred the government to take measures to increase supply, to facilitate privatization, and to reform the price system. End Summary.

Electricity Cut Results from Fixed Prices

12. (SBU) The power cut that affected 13 provinces in Turkey on July 1 precipitated serious debate on Turkey's electricity needs and the viability of the current pricing system. Recent developments pushed the GOT to revise its supply-demand projections for the 2006-2015 period and to take measures to keep private generation companies in the system. After keeping prices at the same level for three years, the GOT is finally considering price increases in electricity and some tax relief measures to support private producers.

13. (SBU) According to Turkish Electricity Transmission Inc.(TEIAS) data, Turkey will produce 173.1 billion kWh electricity and consume 171.4 billion kWh in 2006. The same data indicates that the Turkish state Electricity Generation Inc. (EUAS) plants will produce 38.1%, private Build-Operate-Transfer (BOTs) 9.5%, private Build-Operate (BOs) 23.8%, and "autoproducers" 11.1% of this total. Autoproducers refer to plants that produce for their own needs - usually for an associated factory - and have the right to sell to the grid, but at controlled prices. BO's, BOT's, and autoproducers are mostly gas-fired. (The clean coal-importing Iskenderun BO is the exception.) The Energy Ministry is concerned about increasing reliance on imported natural gas (and about two-thirds of this coming from Russia).

14. (SBU) The GOT's reluctance to increase electricity prices in the

last three years, despite the 60% increase in natural gas prices during the same period, has brought increasing pressure on autoproducers. The gas-fired BOs and BOTs remained unaffected by the natural gas price increases, since they have a pass-through arrangement for their cost inputs. The autoproducers, however, were directly affected by the gas price increase, and their profit margins shrank to such levels that they were recording losses from selling electricity at night time -- when the sales prices are lower. For this reason, the autoproducers had recently been shutting down their generation sales activities at night and had formally expressed their concerns to the GOT.

15. (SBU) This problem finally hit Turkey badly on Jul 1, when the GOT could not get the autoproducers to feed electricity to the grid after one of the transformers in Bursa in north-western Turkey broke. The state distribution company TEDAS was unable to provide electricity to a total of 13 cities around Bursa for 11 hours that night. The government criticized the companies that refused to provide electricity that night, claiming these investments were made for public service. Following these remarks, the Competition Authority initiated an investigation into Ak Enerji, Zorlu, Koc, Sabanci Energy and the Electricity Producers' Association (EUD), to determine whether the companies acted jointly the night of Jul 1. Alarko and Ak Enerji announced on Jul 13 that they would stop generation in their autoproducer facilities as of the end of July, since their cost of production exceeded the sales price. Newspapers reported 7-8 other companies were planning to do the same. Reportedly, the companies are looking for ways to import their own gas to limit their costs (possible in principle, but difficult in practice).

16. (SBU) The GOT is now looking for ways to overcome this growing crisis. According to press reports, the Ministry of Energy is getting ready to announce price increases in electricity as of August. The Ministry is reportedly planning a 5-15% total increase, which it will announce in the coming months. The GOT is also

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working on measures to provide tax relief to producers as a way to lessen the shock and political cost of consumer price increases, although the IMF program restricts their flexibility in this regard.

The Government held summits on July 27 and 31 to consult with industry, and the Council of Ministers underscored the government's intent to institute a combination of tax relief and electricity price increases.

Supply Concerns

17. (SBU) The state electricity transmission company (TEIAS) revised its electricity supply-demand projections for the 2006-2015 period, moving the forecasted gap forward one year. According to the base scenario, which is based on a 7% annual increase in electricity consumption, Turkey will have a 3 billion kWh electricity shortfall in early 2009. In response to the anticipated shortfall, The Energy Minister Hilmi Guler has announced plans to add nuclear to the energy mix (but these would not come on stream until after 2015 in any event), to accelerate plans to privatize some power plants and distribution regions - including hydroelectric facilities, and to establish a balancing and settlement system to facilitate creation of an electricity market.

18. (SBU) The long-delayed launching of privatization of regional electricity distribution companies remains "imminent", but continues to slip. The long awaited announcement of the tariff structure, accompanied by some adjustment in the boundaries of regions, has elicited complaints by a number of companies who have claims arising from earlier failed privatization attempts. American company AES and a number of European companies persevere in their interest.

Trouble at the BO's

19. (SBU) While the BOT's have faced threats and calls for

unilateral price reductions in the past from the GOT, because their transactions were structured with higher prices and guarantees (and higher returns based on a higher risk environment at the time of the deals), they have been quietly producing electricity and have recently stayed off the front pages of the press. It appears that the GOT will continue to honor its contracts to purchase electricity from these four plants (with some EXIM/OPIC exposure). Both BOT's and BO's prices are adjusted for higher natural gas cost inputs, so they are cushioned to some extent, but still rely on payment from state entities.

¶10. (SBU) Recent rulings by the Danistay (Council of State) - stemming from long-standing law suits - put the EXIM/OPIC financed Izmir power plant at risk of closure. This 1400 MW gas-fired Build-Operate (BO) was built by Enka and U.S. Interger, but the latter sold its interests to Enka. The Danistay annulled the underlying Electricity Sales Agreement (between Enka and TETAS - the state electricity trading company) claiming that this was a public service concession on which it should have opined. The GOT assiduously worked to overturn and delay implementation of this decision, finally passing a new law requiring execution of a new Electricity Sales Agreement (ESA) that would be ruled under private law, outside of Danistay jurisdiction.

¶11. (SBU) In response to requests from EXIM and Enka, we gained a verbal affirmation from Treasury officials that the existing Treasury guarantee will still be operative and honored under a new ESA with written affirmation to follow. (The law specifically says this, but the lenders wanted additional comfort and assurance.) Enka signed the new ESA on July 25, barely in advance of the effective deadline created by the Danistay ruling.

¶12. (SBU) EXIM and OPIC financed a portfolio of BO power plants with original exposure of almost \$ 1 billion. Two other plants - Adapazari (Thrace near Istanbul) and Baymina (Ankara) are also at risk, but the law suit is less advanced, and the GOT appears willing to make a comparable fix to avoid losing these significant sources of power for the grid. Despite these woes, Enka announced in the press on August 1 its intent to build another gas-fired power plant in the northwest, but without providing details on the financing structure.

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Comment

¶13. (SBU) Companies and Government Officials remain frustrated by the still under-developed energy market in Turkey (electricity and natural gas). The regulator EMRA is still waiting for a functioning market based on price signals to oversee, which exacerbates turf fighting between EMRA and the Energy Ministry. The relatively small corporate autoproducer segment - which was the core of a potential market-based component - has been squeezed between free cost and wholesale prices but fixed retail prices (alarmingly reminiscent of the crisis in California earlier in this decade). The supply shortage is now foreseen to be coming sooner than the time required for permitting, financing, and building power plants, so it looks like Turkey may face more black-outs. Moreover, Turkey's neighbors do not have excess capacity and it is not economic for Turkey to transmit electricity from its east to its major markets in the west. Turkey's small but important exports to Iraq (Ref A) may be put at risk if domestic supply cannot meet demand. The perception of near crisis and risk of more black-outs may force Turkey to finally take measures needed to stimulate needed investment. On the other hand, the under-developed nature of Turkey's electricity market and the related political challenges are symbolized by the fact that it is the Government cabinet which sets electricity prices.

McEldowney